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Economic and Social Council

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Committee of Experts on International Cooperation in Tax Matters
Tenth session
Geneva, 27-31 October 2014

Provisional agenda and organization of work

1. Opening of the session by the Chair of the Committee.
2. Adoption of the agenda and organization of work.
3. Discussion of substantive issues related to international cooperation in tax matters:
   - (a) Issues related to the updating of the United Nations Model Tax Convention:
     - (i) Article 4 (Resident): application of treaty rules to hybrid entities;
     - (ii) Article 5 (Permanent establishment):
       - a. The meaning of "connected projects";
       - b. Physical presence issue;
     - (iii) Article 8 (Shipping, inland waterways transport and air transport):
       - a. The meaning and coverage of the term "auxiliary activities";
       - b. The application of the article to cruise shipping;
     - (iv) Article 9 (Associated enterprises): update of its commentary and transfer pricing issues;
     - (v) Base erosion and profit shifting;
     - (vi) Article 12 (Royalties): general consideration, including equipment-related issues;
     - (vii) Article 13 (Capital gains): the practical implications of paragraph 4;
     - (viii) Article 23 (Methods for the elimination of double taxation): conflicts of qualification and conflicts of interpretation;
     - (ix) Article 26 (Exchange of information);
     - (x) Taxation of services:

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a. Taxation of services — general discussion;

b. Article on technical services;

c. Other issues;

(b) Other issues:

(i) Issues for the next update of the United Nations Practical Manual on Transfer Pricing for Developing Countries;

(ii) Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries;

(iii) Taxation of the extractive industries;

(iv) Taxation of development projects;

(v) Capacity-building;

(vi) Cooperative compliance and corporate governance in tax matters;

(vii) International trade in goods — tax issues.

4. Dates and provisional agenda for the eleventh session of the Committee.

5. Adoption of the report of the Committee on its tenth session.

Organization of work

Date	*Item*	
Monday, 27 October 2014		
9-10 a.m.		Registration of participants
10-10.45 a.m.	1	Opening of the session by the Chair of the Committee
	2	Adoption of the agenda and organization of work (E/C.18/2014/1)
	3	Discussion of substantive issues related to international cooperation in tax matters:
		(a) Issues related to the updating of the United Nations Model Tax Convention
10.45-11.45 a.m.	3 (a) (i)	Article 4 (Resident): application of treaty rules to hybrid entities
11.45 a.m.-12 p.m.		Coffee break
12-1 p.m.	3 (a) (ii)	Article 5 (Permanent establishment):
		a. The meaning of "connected projects"
1-3 p.m.		Lunch break
3-4 p.m.	3 (a) (ii)	Article 5 (Permanent establishment):
		b. Physical presence issue
4-4.15 p.m.		Coffee break
4.15-6 p.m.	3 (a) (iii)	Article 8 (Shipping, inland waterways transport and air transport):
		a. The meaning and coverage of the term "auxiliary activities";
		b. The application of the article to cruise shipping
Tuesday, 28 October		
10-11.45 a.m.	3 (a) (x)	Taxation of services:
		a. Taxation of services — general discussion;
		b. Article on technical services;
		c. Other issues
11.45 a.m.-12 p.m.		Coffee break

Date	*Item*	
12-1 p.m.	3 (a) (x)	Taxation of services (continued): a. Taxation of services — general discussion; b. Article on technical services; c. Other issues
1-3 p.m.		Lunch break
3-3.30 p.m.	3 (a) (x)	Taxation of services (continued): a. Taxation of services — general discussion; b. Article on technical services; c. Other issues
3.30-4.45 p.m.	3 (b) (v)	Capacity-building Presentation on the capacity development programme of the Financing for Development Office *Presenter*: Secretariat and others
4.45-5 p.m.		Coffee break
5-6 p.m.	3 (a) (viii)	Article 23 (Methods for the elimination of double taxation): conflicts of qualification and conflicts of interpretation *Presenter*: Secretariat and others
Wednesday, 29 October		
10-11.30 a.m.	3 (a) (v)	Base erosion and profit-shifting
11.30-11.45 a.m.		Coffee break
11.45 a.m.-1 p.m.	3 (a) (iv)	Article 9 (Associated enterprises): update of its commentary and transfer pricing issues
1-3 p.m.		Lunch break
3-4.30 p.m.	3 (a) (iv)	Article 9 (Associated enterprises): update of its commentary and transfer pricing issues (continued)
4.30-4.45 p.m.		Coffee break
4.45-6 p.m.	3 (b) (i)	Issues for the next update of the Practical Manual on Transfer Pricing for Developing Countries *Presenter*: Secretariat and others

Date	*Item*	
Thursday, 30 October		
10-11.30 a.m.	3 (a) (vi)	Article 12 (Royalties): general considerations, including equipment-related issues
11.30-11.45 a.m.		Coffee break
11.45 a.m.-1 p.m.	3 (b) (iii)	Taxation of the extractive industries
		Presenter: Secretariat and others
1-3 p.m.		Lunch break
3-4 p.m.	3 (b) (iii)	Taxation of the extractive industries (continued)
		Presenter: Secretariat and others
4-5 p.m.	3 (a) (ix)	Article 26 (Exchange of information)
5-5.15 p.m.		Coffee break
5.15-6 p.m.	3 (b) (iv)	Taxation of development projects
Friday, 31 October		
10-11 a.m.	3 (a) (vii)	Article 13 (Capital gains): the practical implications of paragraph 4
		Presenter: Ms. Pragya Saksena and others
11-11.45 a.m.	3 (b) (ii)	Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries
		Presenter: Mr. Lasars, Secretariat and others
11.45 a.m.-12 p.m.		Coffee break
12-1 p.m.	3 (b) (ii)	Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries (continued)
		Presenter: Mr. Lasars, Secretariat and others
1-3 p.m.		Lunch break
3-3.45 p.m.	3 (b) (vii)	International trade in goods — tax issues
3.45-4.45 p.m.	3 (b) (vi)	Cooperative compliance and corporate governance in tax matters
4.45-5.30 p.m.	4	Dates and provisional agenda for the eleventh session of the Committee
5.30-6 p.m.	5	Adoption of the report of the Committee on its tenth session; closing of the tenth session

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Committee of Experts on International Cooperation in Tax Matters
Tenth session
Geneva, 27-31 October 2014
Item 3 (b) (iii) of the provisional agenda*
Taxation of the extractive industries

Subcommittee on Extractive Industries Taxation Issues for Developing Countries

Note by the Secretariat

Summary

The present note provides a historical perspective on the current status of the discussions on the taxation of extractive industries. It summarizes the discussions leading up to the establishment of the Subcommittee on Extractive Industries Taxation Issues for Developing Countries and the work that the Subcommittee has carried out since its inception.

* E/C.18/2014/1.

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Introduction

1. The taxation of the extractive industries has become a priority of the Committee of Experts on International Cooperation in Tax Matters. The issue arose during the eighth session of the Committee, and a subcommittee was formed at its ninth session.

Eighth session of the Committee (2012)

2. At the eighth session, and building on a prior presentation on the use of tax incentives by Stefan van Parys,[1] Robin Oliver (then a member of the Committee) gave a presentation[2] on how the taxation of foreign capital negatively affects the volume of investment, resulting in lower wages and/or higher unemployment. Discussions were held on issues of location-specific economic rents and their relevance to articles 5 and 7 of the United Nations Model Double Taxation Convention between Developed and Developing Countries, on permanent establishment and business profits, respectively; article 6, on income from immovable property; article 9, on associated enterprises; article 10, on dividends; article 11, on interest; and article 12, on royalties.

3. Following Mr. Oliver's presentation, the Committee discussed issues such as location-specific rents associated with natural resources and the need for appropriate tax policies for resource exploitation. According to a number of participants, many developing countries were losing out on such revenue. Those exploiting the resources were often provided with tax exemptions that could not be economically justified, while their activities led to externalities, for example environmental damage, that negatively affected local communities, which were often not appropriately compensated. Owing to the importance of the issue, the Committee decided that its work on it should continue and that a working group should be formed. However, since the four-year terms of the current membership of the Committee had concluded, the formation of such a working group was deferred to the new membership.

Expert group meeting (May 2013)

4. With a view to assisting the Committee in addressing the agenda item, the Financing for Development Office of the Department of Economic and Social Affairs organized a one-day expert group meeting on 28 May 2013. The discussions focused on the issues that developing countries faced when designing and administering an extractive industries fiscal regime, with a view to ensuring that the tax cooperation work of the United Nations could further support developing countries in that important area of development. During the meeting, participants from national tax authorities, international organizations, non-governmental organizations and the private sector considered the question of international tax cooperation in the extractive industries sector, including institutional arrangements

[1] Available from www.un.org/esa/ffd/tax/sixthsession/UseOfTaxIncentivesALL.pdf.
[2] Available from www.un.org/esa/ffd/tax/eighthsession/PPTs/PPT_CRP11.pdf.

to promote such cooperation. Summaries of the presentations of the participants and the ensuring discussions are contained in a detailed report of the meeting.[3]

Ninth session of the Committee (2013)

5. At the ninth session, the new membership of the Committee decided to form a Subcommittee on Extractive Industries Taxation Issues for Developing Countries with the mandate to consider, report on and propose draft guidance on extractive industries taxation issues. In undertaking its work, the Subcommittee would seek to engage with other organizations that are active in the field. The Subcommittee would comprise representatives from tax administrations having wide and varied experience in dealing with the extractive industries; academia; international organizations; and the private sector, including from petroleum and mining companies.

Subcommittee on Extractive Industries Taxation Issues for Developing Countries

First meeting of the Subcommittee

6. The initial meeting of the Subcommittee, hosted by the South African Revenue Service, was held in Johannesburg, South Africa, in May 2014. Sixteen Subcommittee members participated, representing Governments, business, academia, and regional and international organizations. The main outcome of the meeting was an agreement to focus on areas where the United Nations could add special value, while also drawing upon the work of regional, international and other organizations. The goal was to publish an overview note on issues in that area as well as more detailed policy and administrative guidance notes that focused on the specific taxation and governance aspects of the extractive industries. This included capital gains tax issues in that area, including offshore "indirect" sales of local assets, environmental reclamation, tax treaty issues and value added taxation.

7. Some of the other topics discussed, with a view to deciding on the areas of greatest relevance, included:

- Capital gains taxation of assets in the extractive industries
- Tax treatment of environmental reclamation and rehabilitation
- Double taxation treaty issues
- VAT issues
- Tax incentives applying to the extractive industries
- Tax issues related to price fluctuations
- Ring-fencing issues
- Taxation of service providers to the extractive industries
- Knowledge gap issues
- Windfall taxes

[3] Available from www.un.org/esa/ffd/tax/ninthsession/CRP19_ExtractiveIndustries.pdf.

Second meeting of the Subcommittee

8. The second meeting of the Subcommittee, hosted by the Tanzanian Revenue Authority, was held in Arusha, United Republic of Tanzania, in August 2014. First drafts of various policy and administrative guidance notes were discussed by the members of the Subcommittee.

9. The Subcommittee decided that:

- It would put before the Committee at its tenth session, in October 2014, draft guidance notes or outlines (as appropriate in each case and where possible in respect of relevant time frames) on capital gains on indirect sales, tax treaty issues, certain VAT issues and the tax aspects of decommissioning of extractive projects
- It would also provide the Committee with an outline of a proposed overview note to accompany the specific guidance notes
- In accordance with its mandate, it would provide a work programme for the Committee at its 2014 session that would incorporate other guidance notes proposed for the Subcommittee's focus in 2015 and outline other possible topics for guidance in future years.

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Item 3 (a) (vi) of the provisional agenda*
Discussion of substantive issues related to international cooperation in tax matters: article 12: general consideration, including equipment-related issues

Differences between article 12 of the United Nations Model Double Taxation Convention between Developed and Developing Countries and article 12 of the Organization for Economic Cooperation and Development Model Tax Convention on Income and Capital

Note by the Secretariat

Introduction

1. The present note sets out the main differences between the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention) and the Organization for Economic Cooperation and Development (OECD) Model Tax Convention on Income and Capital (OECD Model Convention) (see table below). In addition, it reflects some of the differing views of the members of the Committee of Experts on International Cooperation in Tax Matters with regard to the relevance of paragraphs 14, 14.1, 14.2, 14.4, 15, 16, 17.2 and 17.3 of the OECD commentary, which arose in discussions at the 2011 session of the Committee and which the Committee may wish to consider in more detail.

* E/C.18/2014/1.

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Differences between the Model Conventions in respect of article 12

Article 12 (Royalties)		
United Nations Model Double Taxation Convention between Developed and Developing Countries	*Organization for Economic Cooperation and Development Model Tax Convention on Income and Capital*	*Differences[a]*
1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State. 2. However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the royalties is a resident of the other Contracting State, the tax so charged shall not exceed __ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the royalties. The competent authorities of the Contracting State shall by mutual agreement settle the mode of application of this limitation.	1. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.	The United Nations Model Convention omits the word "only", which means that royalties may be taxable in the source country as well as the residence country, resulting in departure from the principle of an exclusive residence State's right to tax provided by the Organization for Economic Cooperation and Development (OECD) Model Convention (although the OECD commentary provides an option to tax royalties and many OECD countries have reservations to the OECD Model Convention on this point and include such a provision in treaties). Paragraph 2 of the United Nations Model Convention is an addition flowing logically from the premise of allowable source State taxation. In combination with article 23, article 12 gives the primary right to tax to the source State. The United Nations Model Convention does not present a consensus on a particular rate for the withholding tax to be charged on royalties on a gross basis and thus leaves the rate to be established through bilateral negotiation. The commentary (para. 8ff) notes some of the relevant factors in determining an appropriate rate in the situation of particular countries. The United Nations Model Convention does not reflect the 2003 changes to the OECD Model Convention to introduce the concept of "beneficial" ownership because that concept is included in paragraph 2, which is not in the OECD Model Convention.

Article 12 (Royalties)		
United Nations Model Double Taxation Convention between Developed and Developing Countries	*Organization for Economic Cooperation and Development Model Tax Convention on Income and Capital*	*Differences*[a]
3. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes[b] used for radio or television broadcasting, any patent, trade-mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.	2. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning the industrial, commercial or scientific experience.	The United Nations Model Convention includes so-called "equipment rental", which was deleted from the OECD Model Convention in 1992 (although several OECD countries have reservations on this point). The OECD commentary indicates that this was done to clarify that such income should be taxed as business income under articles 5 and 7. According to the commentary to the OECD Model Convention, the article does not apply to payments for new information obtained as a result of performing services at the request of the payer since it is intended to be limited. Some members of the Committee of Experts on International Cooperation in Tax Matters have taken the view that there is no base for limiting the scope of the industrial, commercial or scientific experience to that arising from previous experience. Some members of the Committee of Experts have expressed the view that the payments referred to in paragraphs 14, 14.1, 14.2, 14.4, 15, 16, 17.2 and 17.3 (dealing with software contracts in particular) of the OECD commentary may, in fact, constitute royalties (see commentary below para. 17.4 (p. 220) of the United Nations Model Convention). These include software-related royalties, such as software transmitted electronically and certain forms of transfer of the full ownership of the rights in the copyright.

Article 12 (Royalties)		
United Nations Model Double Taxation Convention between Developed and Developing Countries	*Organization for Economic Cooperation and Development Model Tax Convention on Income and Capital*	*Differences*[a]
		One member of the Committee of Experts specifically doubted the words in parenthesis in paragraph 16, which relate to geographically based and time-limited rights with regard to the use of the software.
4. The provisions of paragraph 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of Article 7. In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.	3. The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.	The United Nations Model Convention contains a limited force-of-attraction principle. Moreover, the United Nations Model Convention excludes royalties that are received in connection with the business activities described in article 7, paragraph 1 (c) (business activities of the same or similar kind as those of the permanent establishment in the source country). The reference to subparagraph (c) would only be required in a bilateral treaty enshrining the limited force-of-attraction rule — most treaties do not. The United Nations Model Convention refers to paragraph 2 in addition to paragraph 1 because of the source State taxation expressly allowed in that paragraph.
5. Royalties shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.		This paragraph is not found in the OECD Model Convention. It clarifies that royalties are deemed to arise (be sourced) in the State of residence of the payor (except in some fixed-base or permanent establishment cases).

Article 12 (Royalties)		
United Nations Model Double Taxation Convention between Developed and Developing Countries	*Organization for Economic Cooperation and Development Model Tax Convention on Income and Capital*	*Differences*[a]
6. Where by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provision of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.	4. Where by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.	There are no differences between the two Model Conventions.

[a] Differences may also include differences in interpretation as noted in the respective commentaries, which for reasons of brevity are not reproduced in the present annex.

[b] The reference to films or tapes for radio or television was removed from the OECD Model in 2000 so that article 7 or 9 would apply to them.

Additional notes on article 12

Industrial, commercial or scientific equipment and the definition of royalties

2. In the 1977 OECD Model Tax Convention on Income and Capital, the definition of "royalties" included consideration for the use of or the right to use industrial, commercial or scientific equipment. In paragraph 23 of its 1983 report entitled "The taxation of income derived from the leasing of industrial, commercial or scientific equipment",[1] however, OECD concluded that the inclusion of income from the leasing of industrial, commercial or scientific equipment in the royalty definition would not be advisable, could lead to misinterpretation of the objectives of the OECD Model Convention and might even create difficulties in the negotiation of bilateral tax treaties. Subsequently, in the 1992 revision of the OECD Model Convention, consideration for the use of or the right to use equipment was deleted from the definition of "royalties".

3. According to the 1983 OECD report, the Committee on Fiscal Affairs examined whether it seemed appropriate to subject income from the leasing of the use of industrial, commercial or scientific equipment to taxation at source and found that:

(a) Income from the leasing of industrial, commercial or scientific equipment was usually of a different nature than royalties proper for which article 12 had been designed;

(b) Article 12 of the OECD Model Convention provided for a zero-rate of tax for industrial, commercial or scientific equipment at source to protect it from source taxation. The inclusion of industrial, commercial or scientific equipment in the definition of royalties was therefore not meant to imply that where there was a tax on royalties at source it should extend to industrial, commercial or scientific equipment;

(c) When extending taxation at source of royalties proper to income from the leasing of industrial, commercial or scientific equipment, such income would be subject to taxation on a gross basis, which might lead to an excessive tax at the expense of the lessor. Additionally, the tax at source might not be fully credited in the residence country;

(d) Given that taxation on a gross basis would occur only in the absence of a permanent establishment, taxation where a permanent establishment did not exist might be far more burdensome than where it did;

(e) Taxation would in any case occur in those States that considered the residence of the payor as the source of the royalty even if the equipment was not situated in that State.

Link to a provision on taxation of technical services

4. In a paper entitled "Note on a new article of the United Nations Model Convention dealing with the taxation of fees for technical and other services",[2]

[1] Available from www.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-2010/r-2-the-taxation-of-income-derived-from-the-leasing-of-industrial-commercial-or-scientific-equipment_9789264175181-95-en.

[2] Available from www.un.org/esa/ffd/tax/ninthsession/CRP5_Services.pdf.

which he prepared for the ninth session of the Committee of Experts, Brian Arnold addressed the taxation of fees for technical services and concluded that a possible way of dealing with income from technical services would be to allow the source country to tax all payments made by residents of the source country (and non-residents with a permanent establishment or fixed-base in the source country) to the residents of the other country for technical services. Such a treatment is similar to the treatment of royalties under article 12. The source country would be entitled to tax payments for technical services on a gross basis at a rate to be agreed upon through bilateral negotiations by the contracting States. One possible option presented was to amend article 12 to treat fees for technical services as royalties. Another option, and in fact the one chosen by the Committee, was to have a separate article specifically on fees for technical services.

5. A subcommittee on tax treatment of services, coordinated by Liselott Kana, was created and given the following mandate:

> The subcommittee is mandated to address the issue of the taxation treatment of services in general in a broad way. The particular issue of taxation of fees for technical services will be addressed by presenting wording, including different options, for the text of the Article on Technical Services at the tenth session in 2014.[3]

6. In view of the services-related work, it will be necessary to include a definition of "technical services" in the proposed new article on fees for technical services and/or to provide sufficient discussion in the commentary of what constitutes "technical services" and how that relates to the definition of "royalties" in article 12. It may also be necessary to specifically indicate which article takes precedence in the event that, prima facie, both articles apply. This would only be necessary if the taxation results, such as rates, varied between the two articles.

Meaning of the term "industrial, commercial or scientific equipment"

7. During discussions on the update of the United Nations Model Convention held at the 2011 session of the Committee, one member of the Committee noted the lack of any detailed discussion on the meaning of "industrial, commercial or scientific equipment" in the commentary to article 12 and suggested that if the provision were to be retained more guidance would be needed, including what would be covered by the provision and what would be covered by other articles of the United Nations Model Convention.

8. The Coordinator of the Subcommittee on the United Nations Model Tax Convention Update responded by noting that drafting such an explanation was not part of the mandate of the Subcommittee dealing with the update, but that is should considered as an important issue for further consideration by the Committee.

9. The Committee might now wish to consider whether to begin drafting further guidance on the meaning of the term.

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[3] See www.un.org/esa/ffd/tax/subcommittee/TTS.htm.

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Article 9 (associated enterprises): updated of its commentary and transfer pricing issues

Update of the commentary on article 9 of the United Nations Model Double Taxation Convention between Developed and Developing Countries

Note by the Secretariat

Summary

The present note provides a brief background on the update of the commentary on article 9 (Associated enterprises) of the United Nations Model Double Taxation Convention between Developed and Developing Countries. The issue will be discussed at the tenth session of the Committee of Experts on International Cooperation in Tax Matters. The annex to the note contains, for consideration by the Committee, amendments to the commentary proposed by the Subcommittee on Article 9 (Associated Enterprises): Transfer Pricing, in accordance with its mandate.

* E/C.18/2014/1.

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Background

1. In accordance with Economic and Social Council resolution 2004/69, the mandate of the Committee of Experts on International Cooperation in Tax Matters is to keep under review and update as necessary the United Nations Model Double Taxation Convention between Developed and Developing Countries to give special attention to developing countries and countries with economies in transition in dealing with that and other aspects of its mandate.

2. During the previous update of the United Nations Model Convention in 2011, the main issue for the commentary on article 9 related to the wording in paragraph 3, which expressed a recommendation by the former Group of Experts that countries should follow the Organization for Economic Cooperation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereinafter "OECD Transfer Pricing Guidelines"). Following discussions, it was agreed to retain the reference, which endorsed the arm's length principle in determining the transfer pricing issues implicit in article 9 and which recognized the role that the OECD Transfer Pricing Guidelines played in practice in applying the arm's length principle. While most members of the Committee considered that those views were still appropriate, some members raised concerns about the appropriateness of the views of the former Group of Experts, as set out in paragraph 3 and questioned whether they were too broadly stated. In particular, they indicated that the recommendation for countries to follow the OECD Transfer Pricing Guidelines might need to mention that the Guidelines were only for guidance in applying the "arm's length principle. It was agreed to consider those issues further after the finalization of the United Nations Practical Manual on Transfer Pricing for Developing Countries (hereinafter "United Nations Transfer Pricing Manual"), without prejudging the outcome of such consideration. In the meantime, paragraph 3 of the commentary was amended to clarify that the views expressed by the former Group of Experts in the 2001 United Nations Model Convention had not been fully considered by the Committee, although there was universal agreement that the arm's length principle was the foundation of article 9 of the United Nations Model Convention.

3. The Committee has now produced the United Nations Transfer Pricing Manual, which provides guidance on the practical aspects of transfer pricing, focusing on the issues commonly faced by developing countries.

4. At a meeting of the Core Group of the Subcommittee on Article 9 (Associated Enterprises): Transfer Pricing, the commentary on article 9 of the United Nations Model Convention was considered, and a draft text (see annex) proposed. The draft recognizes the value of the OECD Transfer Pricing Guidelines while noting that they are not the only source of guidance. The United Nations Transfer Pricing Manual is also explicitly mentioned as providing authoritative assistance in the field of transfer pricing.

5. The Committee is invited to consider the changes, which attempt to recognize and balance the various perspectives on the above-mentioned issues. If the Committee approves the revised text, or expresses agreement with any of the amendments, the revised commentary will be incorporated into the next version of the United Nations Model Convention, which is expected to be completed within the four-year term of the current members of the Committee.

Annex

Proposed amendments to the commentary on article 9 of the United Nations Model Double Taxation Convention between Developed and Developing Countries

Article 9

Associated enterprises

A. General considerations

1. Article 9 of the United Nations Model Convention reproduces Article 9 of the OECD Model Convention, except for paragraph 3. ~~As noted in paragraph 1 of the OECD Commentary, "[t]his Article deals with adjustments to profits that may be made for tax purposes where transactions have been entered into between associated enterprises (parent and subsidiary companies and companies under common control) on other than arm's length terms".~~ **Both Models embody the same arm's length principle that forms the basis for allocating profits resulting from transactions between associated enterprises. It Article 9** should be considered in conjunction with Article 25 on mutual agreement procedure and Article 26 on exchange of information.

2. The application of the arm's length ~~**rule to**~~ **principle for** the allocation of profits between the associated enterprises presupposes for most countries that the domestic legislation authorizes a determination on the basis of the arm's length principle.

~~**3. With regard to transfer pricing of goods, technology, trademarks and services between associated enterprises and the methodologies which may be applied for determining correct prices where transfers have been made on other than arm's length terms, the former Group of Experts stated that the Contracting States will follow the OECD principles, which are set out in the OECD Transfer Pricing Guidelines. The former Group of Experts, in the United Nations Model Convention revised in 1999, came to the view that these conclusions represent internationally agreed principles and it recommended that the Guidelines should be followed for the application of the arm's length principle which underlies the Article.**~~

~~**The views expressed by the former Group of Experts have not yet been considered fully by the Committee of Experts, as indicated in the Records of its annual sessions.**~~

3. **It is noted that the Commentary of the OECD Model Convention includes the following general statement on the Article:**

> **1. This Article deals with adjustments to profits that may be made for tax purposes where transactions have been entered into between associated enterprises (parent and subsidiary companies and companies under common control) on other than arm's length terms. The Committee[1] has spent considerable time and effort (and continues to do**

[1] **The OECD Committee on Fiscal Affairs.**

so) examining the conditions for the application of this Article, its consequences and the various methodologies which may be applied to adjust profits where transactions have been entered into on other than arm's length terms. Its conclusions are set out in the report entitled *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, which is periodically updated to reflect the progress of the work of the Committee in this area.

4. The OECD Commentary continues by stating that ~~Committee considers that~~ the ~~OECD~~ *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* "represen[t]s internationally agreed principles and provid[e]s guidelines for the application of the arm's length principle of which th[e]~~is~~ Article is the authoritative statement." The Committee considers that those guidelines contain valuable guidance relevant for the application of the arm's length principle under Article 9 of bilateral tax conventions following the two Models. The Committee also considers it to be highly important for avoiding international double taxation of corporate profits that a common understanding prevails on how the arm's length principle should be applied, and that the two Model Conventions provide a common framework for preventing and resolving transfer pricing disputes where they would occur. With that aim in mind the Committee has developed the United Nations Practical Manual on Transfer Pricing for Developing Countries which pays special attention to the experience of developing countries, reflects the realities for such countries, at their relevant stages of capacity development, and seeks broad consistency with the guidance provided by the OECD Transfer Pricing Guidelines.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 9

Paragraph 1

4 5. Paragraph 1 provides that in cases involving associated enterprises, the tax authorities of **a** Contracting States may for the purpose of calculating tax liabilities rewrite the accounts of the enterprises if as a result of the special relationship between the enterprises the accounts do not show the true taxable profits arising in ~~that~~ **those** States. It is evidently appropriate that an adjustment should be sanctioned in such circumstances~~**, and this paragraph calls for little comment**~~. The provision applies only if special conditions have been made or imposed between the two enterprises. Clearly no re-writing of the accounts with a consequential adjustment should be made if the transactions between the associated enterprises have taken place on a normal open market commercial basis, in other words, at arm's length.

5 6. In the OECD Committee on Fiscal Affairs' Report on "Thin Capitalisation",[2] it is stated that there is an interplay between tax treaties and domestic rules on thin capitalisation which is relevant to the scope of the Article. As noted in paragraph 3 of the OECD Commentary on Article 9:

a) The Article does not prevent the application of national rules on thin capitalisation insofar as their effect is to assimilate the profits of the borrower

[2] Adopted by the Council of the OECD on 26 November 1986 and reproduced in volume II of the full-length version of the OECD Model Tax Convention at page R(4)-1.

to an amount corresponding to the profits which would have accrued in an arm's length situation;

b) The Article is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a *prima facie* loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital;

c) The application of rules designed to deal with thin capitalization should normally not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm's length profit, and that this principle should be followed in applying existing tax treaties.

The OECD Commentary continues:

4. The question arises as to whether special procedural rules which some countries have adopted for dealing with transactions between related parties are consistent with the Convention. For instance, it may be asked whether the reversal of the burden of proof or presumptions of any kind which are sometimes found in domestic laws are consistent with the arm's length principle. A number of countries interpret the Article in such a way that it by no means bars the adjustment of profits under national law under conditions that differ from those of the Article and that it has the function of raising the arm's length principle at treaty level. Also, almost all member countries consider that additional information requirements which would be more stringent than the normal requirements, or even a reversal of the burden of proof, would not constitute discrimination within the meaning of Article 24. However, in some cases the application of the national law of some countries may result in adjustments to profits at variance with the principles of the Article. Contracting States are enabled by the Article to deal with such situations by means of corresponding adjustments (see below) and under mutual agreement procedures.

Paragraph 2

67. In the words of the OECD Commentary, "The re-writing of transactions between associated enterprises in the situation envisaged in paragraph 1 may give rise to economic double taxation (taxation of the same income in the hands of different persons), insofar as an enterprise of State A whose profits are revised upwards will be liable to tax on an amount of profit which has already been taxed in the hands of its associated enterprise in State B." The OECD Commentary observes that "[p]aragraph 2 provides that in these circumstances, State B shall make an appropriate adjustment so as to relieve the double taxation".[3]

However, according to the OECD Commentary,

6. [...] an adjustment is not automatically to be made in State B simply because the profits in State A have been increased; the adjustment is due only if State B considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length. In other words, the paragraph may not be invoked and should not be applied where the profits of one associated enterprise are increased to a level which

[3] Paragraph 5 of the OECD Commentary on Article 9.

exceeds what they would have been if they had been correctly computed on an arm's length basis. State B is therefore committed to make an adjustment of the profits of the affiliated company only if it considers that the adjustment made in State A is justified both in principle and as regards the amount.

7. The paragraph does not specify the method by which an adjustment is to be made. OECD member countries use different methods to provide relief in these circumstances and it is therefore left open for Contracting States to agree bilaterally on any specific rules which they wish to add to the Article. Some States, for example, would prefer the system under which, where the profits of enterprise X in State A are increased to what they would have been on an arm's length basis, the adjustment would be made by re-opening the assessment on the associated enterprise Y in State B containing the doubly taxed profits in order to reduce the taxable profit by an appropriate amount. Some other States, on the other hand, would prefer to provide that, for the purposes of Article 23, the doubly taxed profits should be treated in the hands of enterprise Y of State B as if they may be taxed in State A; accordingly, the enterprise of State B is entitled to relief in State B, under Article 23, in respect of tax paid by its associate enterprise in State A.

8. It is not the purpose of the paragraph to deal with what might be called "secondary adjustments". Suppose that an upward revision of taxable profits of enterprise X in State A has been made in accordance with the principle laid down in paragraph 1 and suppose also that an adjustment is made to the profits of enterprise Y in State B in accordance with the principle laid down in paragraph 2. The position has still not been restored exactly to what it would have been had the transactions taken place at arm's length prices because, as a matter of fact, the money representing the profits which are the subject of the adjustment is found in the hands of enterprise Y instead of in those of enterprise X. It can be argued that if arm's length pricing had operated and enterprise X had subsequently wished to transfer these profits to enterprise Y, it would have done so in the form of, for example, a dividend or a royalty (if enterprise Y were the parent of enterprise X) or in the form of, for example, a loan (if enterprise X were the parent of enterprise Y) and that in those circumstances there could have been other tax consequences (*e.g.* the operation of a withholding tax) depending upon the type of income concerned and the provisions of the Article dealing with such income.

9. These secondary adjustments, which would be required to establish the situation exactly as it would have been if transactions had been at arm's length, depend on the facts of the individual case [...]. [N]othing in paragraph 2 prevents such secondary adjustments from being made where they are permitted under the domestic laws of Contracting States.

10. The paragraph also leaves open the question whether there should be a period of time after the expiration of which State B would not be obliged to make an appropriate adjustment to the profits of enterprise Y following an upward revision of the profits of enterprise X in State A. Some States consider that State B's commitment should be open-ended — in other words, that however many years State A goes back to revise assessments, enterprise Y should in equity be assured of an appropriate adjustment in State B. Other States consider that an open-ended commitment of this sort is unreasonable as

a matter of practical administration. In the circumstances, therefore, this problem has not been dealt with in the text of the Article; but Contracting States are left free in bilateral conventions to include, if they wish, provisions dealing with the length of time during which State B is to be under obligation to make an appropriate adjustment [...].

11. If there is a dispute between the parties concerned over the amount and character of the appropriate adjustment, the mutual agreement procedure provided for under Article 25 should be implemented; the Commentary on that Article contains a number of considerations applicable to adjustments of the profits of associated enterprises carried out on the basis of the present Article (following, in particular, adjustment of transfer prices) and to the corresponding adjustments which must then be made in pursuance of paragraph 2 thereof [...].

~~7~~ **8.** The view has been expressed that a correlative adjustment under paragraph 2 could be very costly to a developing country which may consider not including paragraph 2 in its treaties. However, paragraph 2 is an essential aspect of Article 9 and failure to provide a correlative adjustment will result in double taxation, which is contrary to the purpose of the Convention. A country should closely examine the primary adjustment under paragraph 1 before deciding what correlative adjustment is appropriate to reflect the primary adjustment. Some countries take the view that it may be desirable to eliminate the obligation that a State may have to make a correlative adjustment when the other Contracting State has previously adjusted the transfer prices. This approach can be achieved by changing the word "shall" to "may". Contracting States may, during bilateral negotiations, use the word that is convenient. However, there is no consensus on this point and the language of paragraph 2 remains unchanged.

Paragraph 3

8 9. The United Nations Model Convention was amended in 1999 by the insertion of paragraph 3. Paragraph 2 of Article 9 requires a country to make an "appropriate adjustment" (a correlative adjustment) to reflect a change in the transfer price made by a country under Article 9, paragraph 1. ~~**The new**~~ **Paragraph 3** provides that the provisions of paragraph 2 shall not apply where the judicial, administrative or other legal proceedings have resulted in a final ruling that, by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises is liable to penalty with respect to fraud, gross negligence or wilful default. In other words, in case a final order has been passed in a judicial, administrative or other legal proceeding pointing out that in relation to the adjustment of profits under paragraph 1 one of the enterprises is subject to a penalty for fraud, gross negligence or wilful default, there would be no obligation to make the correlative adjustment under paragraph 2. This approach means that a taxpayer may be subject to non-tax and tax penalties. Some countries may consider such double penalties as too harsh, but it should be borne in mind that cases involving the levy of such penalties are likely to be exceptional and there would be no application of this provision in a routine manner.